Public Debt Management Strategy in Croatia

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PRESS RELEASE

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At its session on February 10, 2011, the Government adopted a Public Debt Management Strategy for the period 2011-2013[1], the second such strategy since 2006. Late in January, the Government also reviewed a Pre-Accession Economic Programme proposal for the 2011-2013 period.[2] With the current Public Debt Management Strategy, the set of goals achieved in the implementation of the Economic Recovery Programme[3] is now complete.

A Public Debt Management Strategy is a plan to achieve the desired public debt portfolio structure by which the Government intends to reduce the costs and risks of borrowing. Below is a brief explanation of the budget deficit and public debt developments and the main objectives and targets of the 2006 and 2011 public debt management strategies.

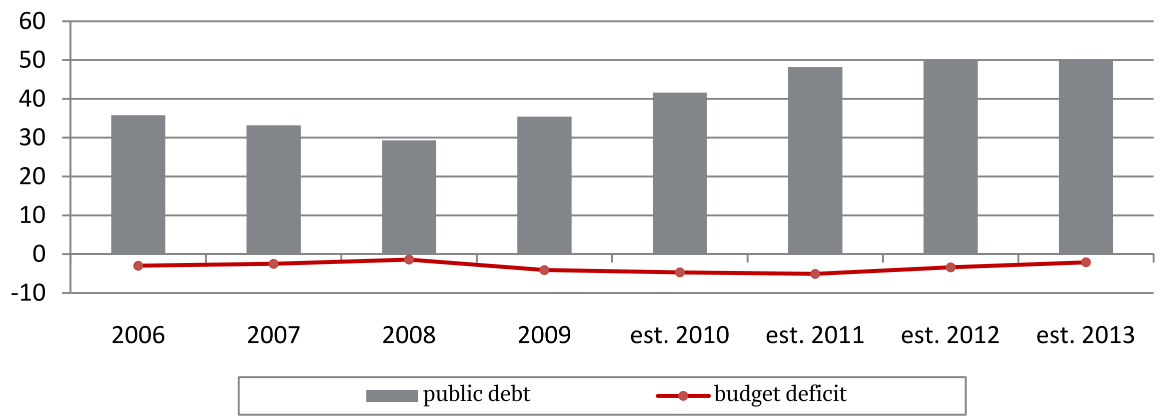
Budget deficit and public debt

The general government budget deficit went down in the 2006-2008 period, but it rose to about 5% of GDP in 2010, as a result of the financial crisis. Its gradual decline is only expected after 2012. Due to the growth of budget deficit, the government's needs for borrowing on both domestic and foreign capital markets increased, so that public debt jumped from 29.3% of GDP in 2008 to 41.6% in 2010. It is expected to go up further to reach 50% of GDP in the coming years.

The principals of two bonds issued on the domestic market (in euro and in kuna) and one euro bond issued on the international market are falling due in the period from 2011 to 2013. It is expected that, from 2011 on, after a long period of time, the budget deficit will be financed from privatisation proceeds (0.5% of GDP in 2011 and 0.2% per year in 2012 and 2013). Apart from the privatisation proceeds, the government will be able to finance the budget deficit or bond repayment with proceeds from the sale of government bonds deposited since 2010, in the Treasury Single Account held with the Croatian National Bank (CNB). However, the receipts from borrowing in 2010 and privatisation will not be sufficient to finance the 2011 budget deficit, so that new loans are likely to be raised on the domestic and foreign capital markets.

[1] http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2011/108_sjednica_vlade_republike_hrvatske
[2] http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2011/105_sjednica_vlade_republike_hrvatske
[3] http://www.vlada.hr/en/naslovnica/novosti_i_najave/2010/travanj/predsjednica_vlade_predstavila_program_gospodarskog_oporavka

Graph 1 General government budget deficit and public debt, 2006-2013 (as a % of GDP)



Source: Government of the RC, 2011. Public Debt Management Strategy, 2011-2013; Pre-accession Economic Programme, 2011-2013.

While implementing the Strategy, the Government fully recognized the risks of protesting government guarantees which rose from HRK 12.4bn in 2005 to HRK 43.4bn in 2010. Added to this should be the HBOR[4] debt (guaranteed jointly and severally, and in its entirety by the government), which went up from HRK 7.6bn in 2005 to HRK 13.7bn in 2010. This indicates that in the coming period, the government will be exposed to not only direct liabilities but also contingent liabilities arising from still active financial guarantees issued for loans to public companies, particularly shipyards. According to the Pre-accession Economic Programme, the tests of public debt sensitivity to changes in contingent liabilities (government guarantees) show that their potential maturity could lead to an increase in public debt to about 50% of GDP by 2012. This calls for a close analysis of the active government guarantees' maturities with projections until 2020. Let us remember that the Government, in order to eliminate the maturity risk of the guarantees, allocated HRK 1bn as guarantee provisions in the 2010 State Budget and the same amount has been provided in the current year state budget. The Government uses the guarantee provisions when the original debtor (a public company) fails to settle its credit liability within the contracted period. The liabilities that remain unsettled affect the public debt growth.

Strategic objectives and targets of public debt management

The main objectives of public debt management in the 2011-13 period are the following: to stabilise the public debt-to-GDP ratio; to extend the average maturity and reduce the share of short-term debt in the total amount of debt; to develop a yield curve[5] for the domestic and foreign markets; to introduce the currency risk hedging; and to promote the domestic securities market.

The strategic objectives are in line with the objectives set up in the 2006 Annual Report on and Strategy of Public Debt Management.

[4] Croatian Bank for Reconstruction and Development.

[5] A yield curve is the representation of the relationship between the yield and maturity of a bond. It provides information on the yield that an investor can expect if he/she has a bond in his/her possession and intends to keep it until it falls due. The development of a yield curve comprises the issue of bonds wit maturities that are not currently presented on the market. In that way, the existing (incomplete) yield curves are completed by new bond issues.

Table 1 Public debt management goals

Annual Report on and Strategy of Public Debt Management (2006), 2007-09	Public Debt Management Strategy (2011), 2011-13
Prudent and careful debt management (optimising the maturity and currency structures of debt)	Contributing to the stabilisation of the public debt-to-GDP ratio.
Transparent and predictable borrowing and debt management	Extending the average maturity and reducing the share of short-term debt in the total amount of debt
Development of a domestic reference yield curve.	Developing yield curves for the domestic and foreign markets.
Introduction of bond issue auctions.	Introducing the currency risk hedging
Release of issuance calendars and quarterly borrowing plans.	On-going development and promotion of the domestic securities market
Introduction of a primary dealer scheme	

Source: Ministry of Finance of the RC, 2006. Annual Report on and Strategy of Public Debt Management and Government of the RC, 2011. a proposal for a Public Debt Management Strategy, 2011-2013".

While at first sight, the 2011 Strategy seems to lack some of the objectives set for 2006, e.g. *the transparent and predictable borrowing and debt management,* and the *release of calendars of borrowing*, these objectives are still included in the new Strategy under the objective *on-going development and promotion of the domestic securities market.* However, it is open to question why the 2011 Strategy abandons the introduction of bond issue auctions and establishment of a primary dealer scheme, which might be a high strategic priority of the government in developing an effective securities market.

Unlike the objectives, strategic targets are desirable values of the public debt structure. They mostly relate to the desirable shares of debt, i.e. the domestic currency and. foreign currency debt, long-term and short-term debt, fixed interest rate and variable interest rate debt, and of target currencies.

Table 2 Strategic public debt management targets

Strategic targets, 2006-09	Strategic targets 2011-13
Reducing the share of foreign-currency debt to about 40% by 2009	Reducing the relative share of short-term debt to 12%-14% of total debt and extending the average maturity
Reducing the share of debt falling due in the following 12 months to about 33% of total debt, and maintaining the average debt maturity at over 3 years	
Reducing the share of debt with variable interest rate to 33% of total debt	

Source: Ministry of Finance of the RC, 2006. Annual Report on and Strategy of Public Debt Management; and Government of the RC, 2011. a proposal for a Public Debt Management Strategy, 2011-2013.

The strategic public debt management targets from 2006 have been partially met:

- the share of short-term debt in total government debt was about 16% at end-September (target: a maximum of 33%);
- the average debt maturity is 4.6 years (target: over 3 years);
- the share of debt with variable interest rate is slightly below 19% (target: a maximum of 33%).

By contrast, the debt currency structure is still far from optimal: in September 2010, the share of foreign currency debt in total debt was over 70% (target: a maximum of 40%).

The new Strategy proposal does not include detailed presentations of all targets, but only those relating to debt maturity adjustment. Thus, the relative share of short-term debt is expected to decrease to 12%-14% of total debt.

There are objective reasons why the Government has limited its strategic targets, such as turbulent conditions on the domestic and foreign financial markets, unsteady budget revenue collection dynamics and contingent liability exposure.

The strongest incentive to improve public debt management, as planned in the new Strategy, will be the introduction of currency risk hedging (currency swap), by which the majority of the USD-denominated debt (about 13% of total government debt) will be substituted by the debt in euros, in order to mitigate the risk of major fluctuations of the USD exchange rate.

In 2010, marketable debt and loans accounted for about 78% and 22% of total government debt respectively. For further development of the public debt market, the government should substitute current loans by marketable instruments, i.e. government bonds. An exception to this may be loans from international financial institutions (World Bank, EBRD, EIB, etc.).

Highly commendable is the release of a T-bill auction calendar, showing that the Government keeps short-term public debt under control and adjusts its maturity with the liquidity situation, and carries out the necessary cash and liquidity management aimed at intra-year budget balancing. However, the task that the Government still has is to place the occasional (daily, weekly or monthly) liquidity surpluses to the organised Zagreb Money Market, instead of depositing them with banks or in the Treasury Single Account with the CNB. By doing so, the Government would directly contribute to a further reduction of money market interest rates and the rates of interest on the Ministry of Finance T-bills.

While the public debt management strategies have mainly been focused on direct government liabilities, in extraordinary situations (e.g. the issuance of government guarantees to shipyards), prudent strategies would also take account of contingent liabilities that are likely to turn into direct liabilities. Including the information on the structure and maturities of government guarantees into the strategy would improve the public debt management and reduce the risks related to the amount and structure of the debt.

It is desirable that the Government should put the current, but also any future public debt management strategy up for discussion, and to submit it to Parliament for formal approval. However, even the formulation of a strategy, which might improve the terms of borrowing and the Republic of Croatia's credit rating, is a major step forward in achieving better public debt management. We hope that an ongoing development of up-to-date annual public debt management strategies will develop into a regular practice for the Croatian public finance.